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TAGS: EFIN ECON ETRD PGOV EC
SUBJECT: GoE TAX REFORMS SEEK TO BOOST REVENUE, LIMIT DOLLAR OUTFLOWS

Summary

¶1. (U) On August 26th the GOE proposed to Congress a tax reform bill, aimed at achieving a more equitable distribution of income, combating tax evasion, and reducing the trade deficit. Private sector representatives say they will have difficulty absorbing the additional costs resulting from the new bill and argue that taxes should not be increased while the country is in the middle of a recession. This reform is expected to pass easily in the current Correa-allied Congress. End Summary.

Measures to combat tax evasion

¶2. (U) In order to reduce tax evasion, the proposal requires greater consistency and transparency in financial reporting by companies. In particular, the proposal requires that companies report the same debt information to financial institutions as reported to the SRI, Ecuador's Internal Revenue Service. Also, in order to deduct certain costs as business expenses, the proposal would require that companies confirm that the payments were made to legitimate businesses, i.e., those businesses included on the GoE's list of entities authorized to issue invoices. The reform would also limit income tax deductions by professionals to 50% of claimed expenses. According to the SRI, these proposals were prompted by concerns that a significant number of companies that have not been paying taxes have reported losses to the SRI while simultaneously reporting healthier income statements to lenders.

Balance of Payments Measures

¶3. (U) The GoE is proposing a number of measures to improve the

country's balance of payments. With oil revenues accounting for about one-third of the GOE's income, the dramatic fall in crude prices from their 2008 highs has negatively affected Ecuador's trade balance. The GOE expects to record a current account deficit of US$1.5 billion for 2009, compared to a US$1.19 billion current account surplus in 2008.

¶4. (U) In an attempt to directly improve the trade balance, the GOE proposes increasing the Luxury Consumptions Tax for alcoholic beverages, cigarettes and soft drinks. The tax on alcoholic beverages, which are mostly imported, would consist of a US$5 per liter specific tax coupled with a 40% ad-valorem tax on those bottles for which the producer has identified a suggested sales price of over US$8.00. When interviewed by the press, local businessmen argued that the GoE's tax on alcoholic beverages is intended to protect the national beer and rum industry. However, some analysts predict the provision will in practice promote greater consumption of smuggled products or artisanal liquors.

¶5. (U) The reform bill also includes a tax of US$0.08 per liter on carbonated drinks. Several analysts warn that this tax will have an inflationary effect due to widespread consumption of soft drinks. In another provision, the tax applied to cigarettes would change from an ad-valorem tax to a specific tax of US$0.07 per cigarette. The effective increase in the cigarette tax per pack ranges from around 18% for some expensive brands to as much as 200% for the least expensive brands. Coordinating Minister of Economic Policy, Diego Borja, identified two objectives for the luxury taxes: 1) to simplify the tax; and 2) to reduce consumption of products that have negative consequences for public health.

¶6. (U) Another provision would raise the capital outflow tax to 2% from 1%, with the ostensible purpose of stemming capital flight. On August 27, President Correa stated that capital outflow so far in 2009 totaled US$ 5.2 billion, compared to US$4.9 billion for all of 2008. However, the President of Ecuador's Federation of Chambers of Commerce argued that the tax increase will not reduce capital outflows because resources are leaving the country due to the insecure investment climate. Sebasti????n Borja, head of the Pichincha Industrials Chamber, said that the capital outflow tax effectively annuls an import tariff reduction applied in 2007 to several raw materials and capital goods. The result, added Borja, would be an increase in production costs and a decline in Ecuadorian companies' competitiveness.

Measures to promote production

¶7. (U) The GoE's bill would grant a 10% income tax exemption to companies reinvesting in productive fixed assets related to research and technology. Another provision under the same heading would eliminate the ability of companies to use as a tax credit the mandatory payment of an "advance income tax" should they end up operating at a loss over the tax period. Any payments made as an advance income tax would be forfeit and used "to compensate for use of public infrastructure," unless an audit by the SRI confirmed the company's loss. Companies will only be able to request an SRI audit once every three years. Coordinating Minister for Production Nathalie Cely has justified this de facto "minimum tax" saying that "All businesses should contribute to the development of the country's infrastructure in order to make it more competitive."

¶8. (SBU) According to economic analyst Walter Spurrier, a minimum income tax, irrespective of reported losses, in a sense assumes that companies reporting losses should be treated as if they are evading taxes. He adds that it is unwise to increase taxes on weak firms, whose closures would affect not only shareholders but also employees and creditors. To reduce a potential negative impact, the SRI is analyzing how to apply exemptions for different sectors, such as for tuna producers or tourism operators.

Other Measures

¶9. (SBU) In another reform, shareholders' dividends will be considered personal income subject to income tax. Since these dividends are also subject to income tax for the company, under the reform, dividends will be charged both the company and personal income tax. This change could undermine Central Bank efforts to promote Ecuador's equity markets through the issuance of a new "stock market" law. Monica Villagomez, President of Quito's Stock Exchange, has commented that stocks and market capitalization are falling because the GoE has contributed to a negative operating environment.

¶10. (SBU) A controversial reform included in the bill is a 12% Value Added Tax (VAT) applied to newspaper print. The print media is interpreting the provision as a direct retaliation against them for critical reporting about GOE actions, and for their demands that the GoE respect the freedom of expression. According to the SRI, collections from this tax will be minimal as most magazines do not use this type of paper and therefore will not be affected. Several prominent economists told visiting USG officials August 27 that the GoE has previously been successful in using its control over spectrum licenses to encourage television and radio media outlets to self-censor their broadcasts. However, print media were heretofore immune to this kind of pressure. This new VAT, according to these analysts, is the GoE's way of sending a message to newspapers that the GoE can find ways to get to them as well.

OVERALL FISCAL IMPACT

¶11. (U) Overall, the GoE expects to collect an additional US$668 million in revenues as a result of the tax reform over the next three years: almost US$49 million in 2009; US$195 million in 2010; and US$425 million in 2011 (when all provisions will have fully entered into force).

Expected Collections (US$ Million)

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Tax                                 2009         2010        2011

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Income tax

--Dividends Income tax---------------------------------------50

--Minimum income tax-----------------------------------------20 0

--Professional expenses deduction----------------------------30

--Profits reinvestment--------------------------------- -----(50)
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Value Added Tax---------------------3.75----------15------ ----15

Luxury Consumptions Tax------------17.5----------70----------70

Capital Outflow Tax----------------27.5---------110---------1 10

TOTAL-----------------------------48.75------ ---195---------425

¶12. (SBU) Ecuador's central government posted a fiscal deficit of $466 million the first semester of 2009 versus a surplus of $325 million in the same period in 2008. Jaime Carrera, head of renowned local think tank, the Fiscal Policy Observatory, said to the press that the GOE is desperately seeking to raise money because it is already in arrears of around $500 million with several public entities. However, according to Minister Cely, the goal of this reform is not just to boost fiscal revenues, but also to ensure that private companies pay the amount of taxes they owe.

Comment

¶13. (SBU) With constrained fiscal resources and a contracting economy, the GOE's planned tax reform primarily aims to generate additional tax revenues and reduce dollar outflows. Several economic analysts argue the GOE is not using tax policy to promote investment or to modulate economic crisis as it should during the current recession. The reform also signals the GOE's interest in promoting the economic model in which the State takes an increasingly larger role in controlling economic activity. End Comment

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